

# Fiduciary Or Force In The 21<sup>st</sup> Century?

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## ABSTRACT

*The rise of China over the past three decades is more than astonishing. Some have considered it to be nothing short of an economic miracle. China has transformed itself from a rural backward economy in 1978 to a thoroughly modern-looking economy and society today. While it took the United States almost 50 years (from 1839-86) to double its per capita GDP, China has done it twice in less than twenty years –from 1978-87 and again from 1987-96. The Chinese economy has improved at such a dramatic rate that many commentators have presumed China's imminent global economic dominance in the 21<sup>st</sup> century. Many now consider geopolitics a bi-polar affair, where only America and China matter. In 2008, for the first time, serious cracks are beginning to surface in the foundations of China's economy, prompting a reconsideration of whether China's future success is as guaranteed and inevitable as first thought. China is facing its most difficult year in this new century. With millions of unemployed workers and a slowing economic growth, China is facing tens of thousands of protests each year. Since the legitimacy of the Chinese government is based on its economic success, China's continued success in the 21<sup>st</sup> century will depend on whether the Communist Party is able to maintain trust in its economy, political system and society. China's economic sustainability rests on whether it can cope successfully with its new-found economic power. The question that has yet to be decided is whether China will adopt a type of fiduciary culture like the ones prevalent in common law countries, such as the U.S. and Britain and its former colony Hong Kong, or will China resort to the use of force to maintain its political and economic power?*

## INTRODUCTION

*The U.S. Fiduciary Culture:* When the United States was first formed in the late 18<sup>th</sup> century, trust was established by the character and charisma of its Founding Fathers, such as George Washington, John Adams, Thomas Jefferson and others. They held the country together through their selfless devotion to the common good of the new nation and the sheer force of their personalities. Over the following two centuries, U.S. institutions and rule of law became firmly entrenched, making the personalities and personal qualities of American leaders much less significant in establishing the necessary trust required to maintain the U.S. economy, political system and society. These established institutions and accompanying legal framework create the fiduciary culture necessary to maintain the United States' free-market economy and democratic republic.

*China's Historically Non-Fiduciary Culture:* China, on the other hand, has a long history of being a non-fiduciary culture. Throughout most of China's 5000 plus year history, trust in China has been established more through personal relationships than reliance on institutions. China's legal institutional framework is much less established than in the U.S., nowhere near as independent as the institutions and legal system in the U.S., and is very fragile. The underlying principles of Chinese culture stem from Confucianism, which has dominated China for thousands of years and forms the philosophical basis of government in China.

Because Confucius lived around 600 B.C. when political, social, and economic chaos prevailed, he set about the task of formulating a new political system and a new social order. According to Confucius, one of the most basic social relationships was between the ruler and the subject, which recognized a clear hierarchical order between them. One of Confucius's famous sayings was "Let the prince be a prince and the subject be a subject." Confucius also argued that the ruler had the absolute moral responsibility for the welfare of the citizenry. If the emperor was truly the "Son of Heaven", he must act in concert with the laws of universe, just as the sun, moon, and

stars move in the heavens according to those same laws. Confucianism required an emperor's daily life be exemplary and without any hint of arbitrary governance. Thus, although subjects were always required to obey a Chinese ruler without question, the ruler was also required to be benevolent and caring towards his subjects. Under Confucianism the power of Chinese rulers was directly tied to their ability to maintain the trust of the citizens, without which there would be no social stability.

Two of the 5 most important virtues in Confucianism are benevolence (Ren) and trustworthiness (Xin). Ren, the highest virtue of Confucianism, refers to the way people relate to one another in Chinese society. There is no simple translation for this word, but in general it means something like a combination of benevolence, sympathy, and good heartedness. It implies sharing the feelings and interest of another. Ren is the closest concept in China to the fiduciary relationship that exists in the U.S., but it depends totally on the individual personality of the ruler, not on any institutions. The credibility and power of the Communist Party today still relies heavily on these Confucian principles, especially since the fledgling institutions to support trust in the society are still very weak.

## **ECONOMIC GROWTH AND DEVELOPMENT**

Throughout most of its history, China has been divided into warring kingdoms or fiefdoms and this has severely hampered its economic development. With the advent of communism in 1949, Chairman Mao's promise of economic development was unfulfilled using the Chinese version of the Soviet central planning economic model. During Mao's regime resources were misallocated to support capital intensive heavy industries while the agricultural sector was neglected. These failed policies kept the country poor and centralized state planning restricted the free flow of labor and capital, immobilizing the factors of production. The Great Leap Forward and the Cultural Revolution resulted in famine, violence, and economic stagnation. China remained inward-looking.

After Mao's death, China's Communist Party made small steps toward freer market policies and in 1978 alone, the Chinese economy quadrupled. Further market reforms were introduced by Communist Party chief, Deng Xiaoping in 1979, creating a more liberalized economic system that became known as "socialism with Chinese characteristics". Under this more open system, foreign trade was encouraged, reversing China's prior isolation. Deng pursued a pragmatic approach to economic development in China; his famous saying was "it doesn't matter what color the cat is, as long as it can catch mice." As part of Deng's economic experimentation he provided incentives that linked material rewards with productivity. He encouraged the creation of new enterprises, allowed foreign direct investment, decentralized production and investment at the provincial level, and fostered greater use of market, rather than the government mechanisms, to channel human and capital resources more effectively throughout the economy.

When Deng died in February 1997, Jiang Zemin succeeded him as the president of the country and head of the Communist Party. Along with his prime minister, Zhu Rongji, Jiang continued to implement more liberal market policies. One of Jiang's greatest accomplishments was to enshrine the role of capitalism in the constitution of the Communist Party. By using a 'Theory of Three Representatives' (farmers, workers, and businessmen), private entrepreneurs were drawn into the party and the 'Three Representatives' theory was also written into the party charter. Thus, the private entrepreneurs responsible for China's growing success were fully accepted by the communist regime.

When China reunified with Hong Kong in July 1997 and joined the World Trade Organization in 2001, foreign direct investment exploded. Its cheap, vast labor pool, an unusually open trade policy, a relatively stable political environment and the potential market of 1.3 billion consumers attracted business investment to China. The main generator of China's dramatic economic growth has been through its exports, especially to the U.S., Europe and Japan, although as their incomes have grown, local consumer demand for goods and services in China has increased as well. By 2004, China was the world's largest exporter of information and communication technology exports and its quest for resources around the world to keep its economy going set off a global commodity boom.

China privatized many of its state owned enterprises and today only a third of the economy is now directly state-controlled. The government's continued investment in public infrastructure also contributed to China's rapid economic growth. China is now the world's 4th largest economy; second-largest, if measured at purchasing-power

parity, a remarkable achievement in such a short period of time. China doubled its per capita GDP from 1978-87 and again in 1987-89. It took the U.S. almost 150 years (1839-86) to double its per capita GDP.

In the 21<sup>st</sup> century, China is an engaged and influential member of the community of nations. Its economic reforms are no longer in doubt and efforts to integrate with the outside world are likely to continue and intensify in the future. But in 2008, with a financial meltdown underway in the U.S., Europe and Japan, serious problems in the Chinese economy have surfaced. U.S. banks have announced hundreds of billions of dollars in losses, with the likelihood that many more hundreds of billions of losses are yet to be recognized. Consumers around the world, maxed out on debt and steadily losing their jobs too, are unlikely to be able to continue purchasing all of the products that China exports. The prospect of millions and millions of Chinese workers without jobs is an increasing threat to the social stability of the country and the power of the Communist government.

With the rest of the world in the doldrums, many pundits are looking to China as the one economy that can save the rest of the world. According to *the Wall Street Journal Online* "... [the] hopes of a world-wide economic recovery increasingly center on continued growth in the developing world, and China in particular."

China's export-led growth that was built on an undervalued yuan, flooded the US with its earned dollars and led to lower interest rates and asset inflation. This encouraged Americans consumers to binge, contributing to America's current financial crisis. Now that this financial crisis has spread to the main street, U.S. consumers are tapped out. Since two-thirds of the US economy is based on consumer expenditures, imports from China have slowed down dramatically.

China is facing massive unemployment especially in the southern part of country, referred to as the workshop of the world. Protests have been going on in different parts of China. Chinese leaders have announced a massive economic stimulus package of 4 trillion yuan (\$586 billion) to stave off the prospect of millions of Chinese losing their jobs in the worsening global economic downturn. China's GDP grew by 7.9% in the second quarter of this year, having grown by 6.1% in the previous three-month period. Investment in fixed assets was 33.5% higher in the first half of this year than a year earlier, reflecting the results of the government's massive fiscal stimulus.<sup>1</sup> China's Shanghai stock market has lost nearly 50% of its value, but has recently bounced back. The stimulus has ignited market speculation, which thus far, the government is not making any attempts to rein in this speculation, fearing the greater danger of angry, unemployed masses.

## **BUMPS ALONG THE WAY**

Although China is enjoying its new prestige as the global economic helmsman, it still has many unresolved problems at home.<sup>2</sup> While the Chinese miracle has been an astonishing feat in many ways, it has also led to some serious challenges to China's continued success in the 21<sup>st</sup> century.

*Income Inequality:* Economic growth in China has been uneven. China faces a widening divide between the "haves" in the cities and the "have-nots" in the countryside. If the Communist Party is not able to push development fast enough to the countryside, such a widening income gap could destabilize the country. The U.S., too, is facing its own difficulties with income disparities in the first decade of the 21<sup>st</sup> century. In 2006, income disparities in the U.S. were as wide as they were in 1928, just before the onset of the Great Depression.

When Deng decided to 'let some get rich first', priority was given to the coastal area. In the 1990s, more than \$300 billion in foreign direct investment was made in China. Since the coastal areas were the first to open up to foreign investment, it is not surprising that this led to richer coastal regions and impoverished hinterlands inland. Markets generally promote efficiency not equality. Although economic development has lifted the income of the Chinese people in general, the upwardly mobile urban dwellers have grown richer faster than the stagnating rural residents. After the Tiananmen Square incident, the Chinese Communist government catered to the needs of the city-dwellers, largely ignoring the needs of the rural communities.

In a recent five-yearly congress held by the Chinese Communist Party, Hu Jintao identified the widening gap between the urban rich and the 800 million rural poor as one of China's major pressing problems. The rural poor

in China today still live in the countryside with an average income of \$1 per day. Because the Chinese Communist Party is very aware how such income gap could destabilize China, it set as one of its most important goals to improve the living standards of the rural poor. When Hu Jintao became President of the Communist Party in Nov. 2002, he personally adopted the goals of improve the living standards of the rural poor and working towards financial transparency.

Restrictions on where people could live and work in China were lifted, enabling millions of the rural poor to flood into the cities to work in the newly-built factories that were churning out export products for the world market. However, millions of these people are now being thrown out of work, often without being paid, when thousands of factories across the country close their doors.

*Land Ownership:* Recently, the Chinese Communist Party passed a law that for the first time in Chinese history recognized private property rights. Unfortunately, these new rights benefit mostly urban-dwellers, allowing the growing middle class in the cities to buy and sell their homes and businesses. In the countryside, where the peasants still only lease their land, rural dwellers are not able to improve their living standards because they cannot use their land as collateral for loans. As has been eloquently described in Hernando de Soto's groundbreaking book, *The Mystery of Capital*, without the ability of the peasants to own their own land, 800 million peasants out of a total population of approximately 1.3 billion, will continue to be mired in poverty.<sup>3</sup> To add insult to injury, some greedy and corrupt local officials have grabbed the peasants' lands to cater to the 'carpet-bagging' real estate developers that have descended on many of the Chinese rural communities.

*Labor discontent:* Massive job cuts and privatization have led to workers' uprisings. In 2008, China introduced a series of labor laws and arbitration to process workers' grievances. The All-China Federation of Trade Unions (ACFTU) is a union bureaucracy controlled by the Communist Party, so there is not exactly independent representation for the workers. Safety is a major concern for many workers; but Chinese workplaces are not governed by clear safety mandates, such as exist in the U.S. OSHA regulated workplaces. According to a lawyer specializing in labor laws, it is likely that unions will play a greater role in the future by helping to draft additional labor laws and representing workers in the collective bargaining process.<sup>4</sup> The Chinese government should consider the creation of genuine independent workers union if it wants to tamp down labor unrest instead of using the union as a tool to represent management.

*No Safety Net:* In the past, state-owned enterprises (SOEs) functioned as parents with fiduciary-like duties to look after the welfare of the workers. When the SOEs were privatized this social safety net was removed and no other social safety net has taken its place. Migrants from the countryside to the cities are still largely excluded from urban social-security plans and they do not receive the subsidized education that city-dwellers enjoy.<sup>5</sup> The Communist Party could address the farmers' concerns through fiscal measures, such as cutting their taxes and providing the rural workers with better healthcare and education, but this has not been done yet.

*Environmental Damage/No Due Process:* In its rush to industrialize China has left a trail of pollution across the country. Twenty of the world's 30 most polluted cities are now in China. Despite recently enacted environmental protection laws, the environment continues to deteriorate and as many 750,000 deaths each year may be caused by pollution-related diseases. In addition, China is about 30 years behind the U.S. schedule of environmental regulation and 10 to 20 years behind Europe. China's legal system remains a stumbling block for effective environmental enforcement. For example, when an environmental activist fought for years to stop chemical companies from dumping untreated waste in China's third largest freshwater lake, Lake Tai, he was recently convicted of blackmail and fraud, even though authorities had already agreed to invest billions to clean up the lake. His criminal troubles arose when he protested against the collusion of authorities with the chemical companies and attracted significant media attention. Even though his confession was extracted through torture, his conviction has been upheld by both the initial court and the appeals court.<sup>6</sup>

*Safety and Quality:* The Chinese press reported on Sept 10, 2008 that a large dairy farm had put melamine in its baby milk formula, sickening thousands of Chinese babies. The contamination scandal quickly spread to 21 producers of a wide range of Chinese-made products such as yogurt, sweets and cake. All of these products were tainted with melamine, a chemical used to hide the fact that the milk has been watered down. Four children died and

more than 50,000 people became ill. Although the problem was detected early August, information was not released immediately for fear of ruining China's reputation during the Olympics. This prompted several countries in Asia and Africa to ban imports of Chinese dairy products and testing of Chinese food products has been stepped up in Europe and the U.S. There had been earlier reports of product contamination such as toothpaste and dog food, which also lead to mass illness and even death. These public reports of product contaminations have damaged the perception of goods 'Made in China.' Since regulation is the responsibility of the Chinese Communist Party, companies close to party leaders usually get away with lax enforcement – at least until there is a problem, when the punishment could be draconian depending on how publicly it embarrasses the Chinese government. Unless the regulatory and judicial systems in China become more independent and cronyism is elimination, Communist party leaders generally ignore problems until they breakdown. Foreign companies have been concerned about the possibility of just such scandals for some time, which is why they have kept full control of all operations, created their own supply chain, or imposed stringent rules on their suppliers.

### **TOWARDS A FIDUCIARY CULTURE?**

China's economy is now so large, complex and globally inter-connected that it may no longer be possible for China to rely on the Communist Party itself to establish trust in the economy and society. If China wants to attract foreign investors to its stock market in Shanghai, it will have to provide sufficient regulation and protection so that investors trust its stock exchange. If the Communist Party wants to maintain social harmony and social control, only fair and independent legal institutions may be capable of providing the necessary trust between the people and the Communist Party.

There are indications that at least in principle the Chinese Communist Party is becoming more aware of the need to create a fiduciary culture in China that relies on independent institutions outside of the control of the Communist Party for enforcement. Although some corporate governance reforms were instituted in China for publicly traded companies, serious corporation scandals have still occurred. According to Tong Daochi of the China Securities Regulatory Commission<sup>7</sup>, even companies thought to be blue-chip with high stock prices before their collapse, were found to be based on inflated profit figures. In 2001 a regulation was passed requiring that one-third of the company boards be independent by June. 2003.<sup>8</sup> Controlling shareholders for the first time had fiduciary duties to the company and to other shareholders and directors were required to have a fiduciary duty of care.<sup>9</sup> Another indication of the movement towards a more fiduciary culture rather than a culture of force is that the vice-president of China's supreme court recently announced that China would reduce death penalty executions 'to an extremely small number'. This would be a significant change. In 2008, China executed more than 1700 people or 72% of the world's total.<sup>10</sup> China has a long way to go to establish a true fiduciary culture and no doubt, it too, will have unique Chinese characteristics, but the reality is that success in the 21<sup>st</sup> century depends on each country's ability to develop some type of culture that is dependent on trust, not force, which means some type of fiduciary culture.

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<sup>1</sup> *The Economist*, July 16, 2009, p.7

<sup>2</sup> *Economist* May 23, 2009, p. 47

<sup>3</sup> Hernando de Soto, *The Mystery of Capital: Why Capitalism Triumphs in the West and Fails Everywhere Else*, (New York: Basic Books, 2000)

<sup>4</sup> *The Economist*, Aug. 1, 2009, p. 37

<sup>5</sup> Promises, Promises, *The Economist*, Oct. 18, 2008,

[http://www.economist.com/world/asia/displaystory.cfm?story\\_id=12437707](http://www.economist.com/world/asia/displaystory.cfm?story_id=12437707), (accessed Dec. 1, 2008)

<sup>6</sup> Joseph Kahn, Protector of Lake Loses Appeal in Chinese Court, *N.Y. Times*, Nov. 6, 2007, p. A5

<sup>7</sup> Tong Daochi, Comparative Corporate Governance: The Case of Chinese Publicly Listed Companies, China Securities Regulatory Commission, [http://www.rieti.go.jp/jp/events/03010801/pdf/Tong\\_p.pdf](http://www.rieti.go.jp/jp/events/03010801/pdf/Tong_p.pdf) (accessed Dec. 1, 2008)

<sup>8</sup> *Ibid.*, China Securities Regulatory Commission, <http://www.csrc.gov.cn> (accessed Dec. 1, 2008)

<sup>9</sup> *Ibid.*

<sup>10</sup> *The Economist*, Aug. 1, 2009, p. 6.

**NOTES**